

REINVENTING THE WHEEL: the false debate of public vs private investment

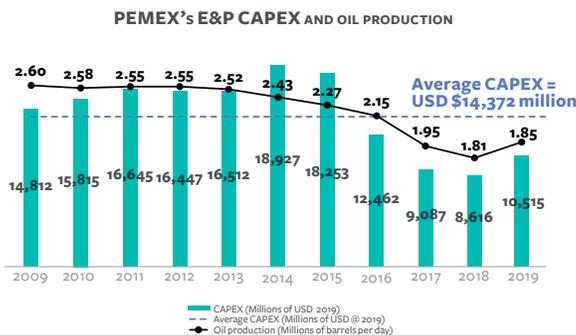
At almost 3 months from the start of the new administration, there is a worldwide concern regarding the relationship between the Mexican oil and gas industry and AMLO's government. However, there are important reasons to believe that sooner than later, the new government will realize the necessity of private sector participation in upstream activities just as the two former administrations did during the last 12 years.

1.- AMLO'S CURRENT POSITION TOWARDS PRIVATE PARTICIPATION IN O&G ACTIVITIES

It appears that the new government has the misconception that oil and gas public and private investment are competing forces rather than complement each other. This is reflected by the constant complaint over the "poor" performance of oil and gas contracts, as private operators are not investing what they promised (even though the government holds work commitment guarantees of USD\$3,867 million) and by the idea that PEMEX alone can produce more and better Mexican mineral resources.

2.- THE IMPOSSIBILITY OF THE ONE COMPANY MODEL

Government is expecting to increase oil production to 2.4 million barrels per day by 2024, but this will be impossible using exclusively service contracts. According to CNH, PEMEX requires to invest USD\$20,000 million per year to revert the production declining trend. However, barely half of this requirement was allocated for 2019 (USD\$10,515 million). On the other hand, the following graph clearly shows that even in times of high CAPEX (2009-2015), PEMEX was not able to stop the production fall. This suggests that in addition to doubling CAPEX, the National Oil Company requires to expand its operational and technological capabilities.



From 2009 to 2014: an increasing CAPEX (averaging USD\$16,773 million per year).

From 2015 to 2018: 53% reduction in CAPEX (averaging 10,055 million per year).

3.- REINVENTING THE WHEEL: THE CHALLENGE OF AMLO'S ADMINISTRATION AND THE OPPORTUNITY FOR PRIVATE INVESTMENT

The current administration has announced a "new" plan to revert declining production with service contracts called CSIEEs, disregarding the fact that this was exactly how the industry operated from 2008 to 2013 without any significant results. By 2013, the government realized that a major overhaul was needed so the Energy Reform introduced a very successful bidding-round system with more efficient contractual models like Production Sharing Contracts or Licenses and the possibility for Pemex to farmout its Entitlements.

From the E&P Mexican learning curve of the last 10 years, we can expect that CSIEEs will be insufficient to revert the declining production and the new government will have no other alternative than taking advantage of the mechanisms of farmouts and bidding rounds, given that 20% of government revenue still depends on oil rent.

Some considerations about the inevitable decision to complement Public and Private investment.

- Public investment was insufficient to fulfill work commitments of 79 of 103 exploration entitlements assigned in Round Zero within the legal term of 3 years (Aug 2017).
- Pemex's financial debt is at its highest with more than 100 billion .
- Financial rating agencies, like Fitch and Moody's) have been downgrading PEMEX's financial position as its current upstream business plan is insufficient to stop declining reserves and production.
- Credit ratings are critical to public finances as government revenue depends on oil rent by 20%
- Private investment potential is key to complement public activities mainly in areas where PEMEX is not working. In just three years of tenders, \$3,867 million of investment were committed. This is equivalent to 37% of the Public Budget allocated to Pemex's E&P in 2019.

- The largest potential lies in farmouts of Pemex. Farmouts benefit is twofold as it is the fastest mechanism to stop declining production and it could strength PEMEX'S financial, operational and technological capabilities.

We are a unique firm integrated by experts in energy regulation and public administration, conformed by a professional team with vast experience in the evolution of the energy sector during the last 10 years.

ANALYSTS



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